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Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554

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In the Matter of

Access Charge Reform

Price Cap Performance Review  
for Local Exchange Carriers

Transport Rate Structure and Pricing  
Under Price Cap Regulation

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

CC Docket No. 96-262

CC Docket No. 94-1

CC Docket No. 91-213

**JOINT REPLY COMMENTS OF  
BELL ATLANTIC AND NYNEX**

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**I. Introduction and Summary**

Many commenters hope to take advantage of this proceeding to obtain drastic -- and unwarranted -- reductions in access charges that would cripple the ability of the LECs to continue providing the quality local telephone service that customers expect and deserve. True reform of access charges is not a question of price *level*, but of price *structure*. The level of access charges is governed by the Commission's price cap rules. As the Commission explained in the Notice of

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<sup>1</sup> The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; and Bell Atlantic-West Virginia, Inc.

<sup>2</sup> The NYNEX Telephone Companies ("NYNEX") are New York Telephone Company and New England Telephone and Telegraph Company.

Proposed Rulemaking,<sup>3</sup> "[o]ur goal is to end up with access charge rate *structures* that a competitive market for access services would provide."<sup>4</sup> The Commission should not allow the commenters to confuse the issue of the appropriate structure for access charges with the issue of the overall amount of revenues that the local exchange carriers ("LECs") need to recover their costs.

While the current usage-based charges for interstate access services do exceed the traffic-sensitive costs that the LECs incur to provide interstate switched access services, this does not mean that the Commission can or should disallow the difference between current rates and cost. The current rates are the product of the Commission's Part 32 accounting, Part 36 separations, and Part 69 access rules, which allocate a specific amount of costs to the interstate jurisdiction, and which require the LECs to recover these costs primarily through usage-based charges. These are real costs that the LECs incur to provide both local exchange service and carrier access service, and the Commission cannot disclaim responsibility for costs that its rules have assigned to the interstate jurisdiction. It would be contrary to the Communications Act, and unconstitutional, for the Commission to prohibit the LECs from charging rates that are necessary to recover these costs.

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<sup>3</sup> *Access Charge Reform*, CC Docket No. 92-262, Notice of Proposed Rulemaking, FCC 96-488 (rel. Dec. 24, 1996) ("Notice").

<sup>4</sup> *Id.*, ¶ 13 (emphasis added).

Price level is an issue that the Commission should address in the context of price caps. While the Commission can, with an appropriate record, modify the price cap productivity factor to reflect the LECs' actual productivity, it cannot apply an arbitrary factor designed to force access charges over time to total element long run incremental cost ("TELRIC") or total service long run incremental cost ("TSLRIC"), as some commenters propose. This would have no relationship with actual or achievable interstate costs, and it clearly would be arbitrary and capricious.

Many commenters urge the Commission to adopt a prescriptive approach to access charge reform. This would be completely antithetical to the purpose of the Telecommunications Act of 1996. The proponents of the prescriptive approach believe that the Commission can replicate the prices that would be produced by a competitive market using TELRIC or similar methodologies based on computer models of the forward-looking incremental costs of a hypothetical least-cost provider. The reality is that no regulatory method, however enlightened or thorough, can replicate a freely competitive market. That is one reason why deregulation tends to produce increased efficiency, lower prices, and greater consumer benefits than governmental price controls. Imposition of stringent price controls by the Commission would not replicate a competitive market, it would supplant it. This is evident from the comments of some commenters who advocate a prescriptive model, who are driven to the inevitable

conclusion that the prescriptive approach will only work if the Commission regulates the rates of new entrants as well as incumbent LECs. Clearly, this approach will not lead the Commission to the Congressional goal of a "deregulatory national policy framework" for the telecommunications industry.<sup>5</sup>

The Telecommunications Act of 1996 was designed to promote competition, not to usher in a new, more stringent regulatory regime that would short change the LECs and prevent the market from determining prices and efficiently allocating resources. The Commission should carry out the purposes of the Act by (1) restructuring access charges to align rates more closely with the manner in which the relevant costs are incurred; (2) providing a revenue neutral restructuring that will give the LECs the opportunity to recover their interstate-allocated costs, but not a guarantee that they will recover those costs if they lose customers to competitors; and (3) provide for increased pricing flexibility as markets become open to competition. This will result in more efficient pricing of interstate access services, while providing a transition from regulatory controls to market discipline as markets become contestable.

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<sup>5</sup> S. Conf. Rep. No. 458, 104th Cong., 2d Sess., 113 (1996).

## **II. The Prescriptive Approach Is Contrary To The Act And Will Stifle The Competitive Market. (Paras. 218-240)**

### **A. A Prescriptive Approach Is Not Required By The Act. (Paras. 218-222)**

Several commenters argue that access reform is required by the Telecommunications Act of 1996, because Section 254 of the Act requires the Commission to make support of universal service "explicit," and because Section 252(d)(1) requires the Commission to establish cost-based rates for interconnection.<sup>6</sup> This leads them to the conclusion that the Act requires the Commission to adopt a prescriptive approach that would reduce access rates to the TELRIC levels that the Commission prescribed for unbundled network elements ("UNEs") under sections 251 and 252 of the Act.<sup>7</sup>

This is incorrect. Although access charge reform is needed to allow a more cost-based rate structure, and to promote many of the objectives of the Act, it is not a specific requirement of the Act, and it is not subsumed in the universal service or interconnection requirements. Access reform should be pursued because it would allow more efficient pricing of access services. This would

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<sup>6</sup> See, e.g., MCI at 9-10.

<sup>7</sup> See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, FCC 96-235, released August 8, 1996 ("Interconnection Order"), ¶¶ 674-703. The TELRIC pricing rules have been stayed pending appeal. See *Iowa Utilities Board v. FCC*, Case Nos. 96-3321 et al., Order Granting Stay Pending Judicial Review (8th Cir., Oct. 15, 1996).

benefit the LECs, their access customers, and consumers of both local and long distance services. However, the Act does not require access charges to be reduced to TELRIC, TSLRIC, or any other standard. In fact, the Act did not require the Commission to take any action at all with regard to interstate access charges.

Sections 251 and 252 have nothing to do with the issue of access charge reform. Those provisions establish new LEC obligations to provide interconnection and unbundled network elements. In the Interconnection Order, the Commission made it clear that these interconnection obligations were in addition to, and not intended to replace, the LECs' existing access services.<sup>8</sup> Rates for access services are governed by Section 201 of the Act, not Sections 251 or 252. Section 251(i) makes it perfectly clear that "nothing in this section shall be construed to limit or otherwise affect the Commission's authority under Section 201."

Section 254 of the Act requires the Commission to develop explicit support mechanisms for universal service.<sup>9</sup> The Commission is conducting an investigation in Docket 96-45 to develop such a fund. Certain amounts of funds that LECs receive from the new universal service fund may be used to reduce or

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<sup>8</sup> See Interconnection Order, ¶¶ 190-91, 363. The Commission found that the provider of the underlying facilities, either the LEC or the carrier purchasing UNEs, is entitled to apply access charges to interexchange carriers ("IXCs") that originate or terminate traffic over those facilities.

<sup>9</sup> See 47 U.S.C. § 254(b)(5), (e).

offset current revenues from interstate access services. However, those funds will not allow the LECs to reduce their access charges to TELRIC or TSLRIC levels, because the universal service fund will only provide support for services that fall within the definition of universal service, *i.e.*, support to high cost areas, low-income subscribers, schools, libraries, and health care providers.

As Bell Atlantic and NYNEX demonstrated in their initial comments, the Commission's rules allocate a disproportionate share of total company costs to the interstate jurisdiction. Those costs include much more than the costs of universal service as defined in Section 254. Interstate access charges provide support for residential service in both high-cost and low-cost areas. The definitions of universal service in Section 254 would not permit, or require, the Commission to replace all of the excess interstate cost allocations with universal service funding. Unless and until a Joint Board reviews earlier separations decisions and explicitly concludes that (i) its allocation of costs between the interstate and intrastate jurisdiction is intended to subsidize universal service as defined in the Act, and (ii) the amount of costs that represent that subsidy, neither the Commission nor the Federal-State Joint Board on Universal Service has any basis for treating any portion of interstate access rates as a federal universal service subsidy.

**B. An Overall Reduction In Access Charges Is Not Necessary To Promote Competition. (Paras. 223-235)**

The advocates of a prescriptive approach urge the Commission to reduce the LECs' access charges to TELRIC levels on the grounds that it would (1) promote competition in both the long distance and local markets; and (2) eliminate excessive LEC costs due to factors such as over-building, misallocations of costs, excess earnings, and general inefficiencies.<sup>10</sup> Both of these allegations are wrong.

A reduction of existing access charges to TELRIC levels, whether through immediate reinitialization of price cap indexes or through a multi-year transition, is not necessary to promote competition. In fact, it would impede the development of a competitive market. The current system of access charges has not impeded long distance competition, and the Commission's imputation rules ensure that the LEC long distance affiliates will have no advantage over non-affiliated long distance companies. The benefits of restructuring do not require an overall reduction in the level of access charges. Local competition would not be enhanced by reductions in access charges, since new entrants generally have a pricing advantage if the incumbent rates are considered too high.

It is far more likely that a prescriptive approach that drove LEC access rates to TELRIC levels would impede competition.<sup>11</sup> The Commission cannot be

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<sup>10</sup> See, e.g., AT&T at 11-13.

<sup>11</sup> See, e.g., ALTS at 21-23; TCG at 3-5.

sure, no matter how carefully it constructs its proxy models, that the TELRIC rates would match the rates that would attract entry in a competitive market.<sup>12</sup> In fact, by pricing LEC services on the basis of a proxy model that assumes a hypothetical, least cost network rather than the existing LEC network, the Commission would prevent new entrants that were more efficient than the incumbent LECs from gaining a competitive advantage in the local telephone market.

The comments of the advocates of a prescriptive approach reveal their underlying mistrust of the market, and their desire not to replicate the competitive market, but to supplant it. For example, WorldCom forthrightly states its belief that access services will *never* be competitive, because "stand-alone" IXC's that do not provide local service will always be at the mercy of the access charges demanded by the local service provider.<sup>13</sup> For this reason, they believe that the Commission should tightly regulate access rates, no matter how contestable the local market becomes.

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<sup>12</sup> The IXCs are unconcerned about how precise TELRIC rates need to be. While they recognize that the TSLRIC of interstate access services may be different from the TELRIC of unbundled network elements ("UNEs"), they argue that the Commission should simply use the results of TELRIC studies to price both access services and UNEs. *See, e.g.,* MCI at 20. However, TELRIC pricing does not include the retail and customer contact costs that the LECs incur to provide access services, and the TSLRIC of access services generally involves more common cost allocations than TELRIC pricing of UNEs.

<sup>13</sup> *See* WorldCom at 13-19; *see also* AT&T at 44-47.

This is directly contrary to the purpose of the Telecommunications Act of 1996, and it is also bad economics. There is nothing unique about the telecommunications market that makes it immune to the law of supply and demand, or that requires perpetual government regulation. An IXC does not have to become a full service provider of both local and long distance services in order to avoid "excessive" access charges. Even a stand-alone IXC will benefit from competition in the local telephone market by having alternative choices of access providers.

As the IXCs note, access services are an input to their provision of long distance services. Practically all providers of services and products use inputs from other firms. For example, automobile producers are dependent on suppliers of steel, and computer makers are dependent on suppliers of computer chips and other components. While some producers may act as both suppliers of inputs and producers of the final product, non-vertically integrated firms are not disadvantaged so long as there is competition among providers of those inputs.

Similarly, stand-alone IXCs will be able to obtain access services at reasonable rates if there is effective competition at the local level. To be competitive, a local telephone company will need to offer a package of services to end users that will include local telephone lines, local usage, vertical features, toll services, and access to long distance companies. If the access charges of the LEC or CLEC are too high, IXCs are not likely to pursue customers of those local

carriers, or to offer them attractive rates for long distance services. A LEC or CLEC with reasonable access charges will be able to offer its customers a wider choice of IXC services, which will give it a competitive advantage over LECs or CLECs who try to limit customers to in-house or affiliated long distance carriers. This competitive situation would give stand-alone IXCs additional protection from paying above-market rates for access services.

While it has not been shown that a prescriptive reduction of access rates to TELRIC levels would benefit competition, it is clear that such a reduction would cause serious harm to the incumbent LECs. Absent a revision of the Part 36 separations rules to assign more costs to the state jurisdiction, TELRIC-based rates would eliminate the cash flow that the LECs use to support their network. For example, NYNEX today receives approximately \$1.8 billion in revenues from interstate switched access services, based on an average per-minute rate of 3.5 cents. TELRIC usage-based rates in the Interconnection Order and in state arbitrations generally do not exceed 1 cent per minute.<sup>14</sup> A reduction in access charges to 1 cent per minute would reduce NYNEX's revenues by \$1.3 billion. This is almost the entire amount of net profits that NYNEX received from all of its operations in 1995. Losses of revenues at this scale would cripple the LECs.

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<sup>14</sup> See Interconnection Order, ¶ 815; Communications Daily, October 8, 1996; October 29, 1996.

No one has shown how the LECs could meet their current costs in the face of such drastic rate reductions.

Some commenters argue that the Commission should deny the RBOCs long distance authority until access rates are reduced to a TELRIC level.<sup>15</sup> The long distance carriers argue that unless access rates are prescriptively reduced to TELRIC, RBOCs entering the long distance market will engage in a "price squeeze" by charging competing long distance carriers high prices for terminating switched access while supplying their own long distance affiliates with access at cost.<sup>16</sup> The Commission recently considered that argument and concluded that the Act gives the long distance carriers power to defeat any such scheme.<sup>17</sup> As the Commission observed:

For example, under the provisions of Section 251, a competitor could purchase the interLATA service on a wholesale basis or purchase unbundled network elements to compete with [the RBOC's] offering. As

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<sup>15</sup> See, e.g., AARP at 9-10; MCI at 37-44; Sprint at 36-37; ACC at 9.

<sup>16</sup> See, e.g., MCI at 35-37. MCI complains that NYNEX is already engaging in a price squeeze in Arizona by marketing long distance services at lower prices for calls that terminate in the NYNEX region. *Id.* at 35. MCI is wrong. This does not demonstrate that NYNEX has any pricing advantage. NYNEX provides out-of-region long distance services by reselling the services of an unaffiliated IXC, who pays the same access charges for terminating calls in the NYNEX region as other IXCs. NYNEX is offering lower rates for calls to the NYNEX region as a marketing tool to identify customers with a community of interest with customers in the NYNEX region. The discount is similar to the discounts that other IXCs (such as MCI with its "Friends and Family" plan) offer to attract and retain customers.

<sup>17</sup> See *Applications of Pacific Telesis Group and SBC Communications, Inc. for Consent to Transfer Control of Pacific Telesis Group and its Subsidiaries*, Report No. LB-96-32, Memorandum Opinion and Order (Jan. 31, 1997), ¶¶ 51 - 54.

long as the incumbent LEC is required to offer unbundled network elements and resale of retail services, an attempted price squeeze is unlikely to be an effective anti-competitive tool.<sup>18</sup>

The Act's requirement that the RBOC must charge its affiliate the same rate for access as it charges other long distance carriers provides additional protection from any potential price squeeze. As the Commission noted, "[p]rice discrimination . . . is relatively easy for [the Commission] and others to detect, and is therefore unlikely to occur."<sup>19</sup>

The most effective deterrent for such behavior, however, is that a price squeeze is not in an RBOC's economic self-interest.<sup>20</sup> The RBOC is far better off receiving the access charge revenues from unaffiliated IXC's that it needs to support its local exchange services than to provide access services to its long distance affiliate at a loss. A price squeeze would be irrational unless an RBOC believed it could drive the other IXC's out of the long distance market and later recoup its losses. No RBOC could seriously believe that it would be able to drive carriers like AT&T, MCI and Sprint out of the market.

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<sup>18</sup> *Id.*, ¶ 54 (footnote omitted); *see also Implementation of Non-Accounting Safeguards*, CC Docket No. 96-149, First Report and Order and Further Notice of Proposed Rulemaking, FCC 96-489, rel. December 24, 1996, ¶ 258.

<sup>19</sup> *Id.*, ¶ 53.

<sup>20</sup> *See* Joint Comments of Bell Atlantic and NYNEX at 13-15 ("Joint Comments").

**C. Prescribing Rates That Do Not Cover LEC Interstate Costs Is Unlawful. (Paras. 236-240)**

The IXC's go through a variety of contortions to avoid recognizing the simple legal principle that a regulator must provide a regulated company with an opportunity to recover its actual costs and earn a fair return on its investment.<sup>21</sup> Basing rates on hypothetical forward-looking cost models -- which ignore historical costs and which do not allow an opportunity for recovery and return on all ongoing costs -- fails to meet that constitutional standard.

The Commission has recognized this obligation. In argument before the 8th Circuit Court of Appeals, the Commission assured the Court that "it has never been the Commission's position that the legitimate embedded costs get stranded; that ILECs should never be able to recover them."<sup>22</sup> Indeed, the Commission identified this access reform proceeding as a forum where recovery of these costs will be addressed.<sup>23</sup>

MCI and other parties argue that the Commission can impose drastic reductions in access rates because any LEC losses "will be more than offset by the new opportunities that await them in long distance, video and other competitive markets once the incumbent LECs stop erecting barriers to local competition."<sup>24</sup>

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<sup>21</sup> See *Brooks-Scanlon Co. v. Railroad Comm'n of Louisiana*, 251 U.S. 396 (1920); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

<sup>22</sup> *Iowa Utilities Board v. FCC*, Case Nos. 96-3321 *et. al*, Transcript of Oral Argument on Petitions for Review at 55, Jan. 17, 1997 (8th Cir.).

<sup>23</sup> *Id.*

<sup>24</sup> MCI at 3.

This argument is flawed as a matter of fact, law and policy. First, the argument is factually flawed. Because the new markets that LECs will be entering will be highly competitive, LECs will not be able to recover all the costs that today are assigned by the separations process for recovery through access charges. Indeed, the reported experience of GTE suggests that LECs could be hard-pressed to recover just the new incremental costs associated with the expansion into long distance.<sup>25</sup> Second, it is long-standing law that a regulator cannot justify offsetting a loss on the regulated business with profits from a competitive business. The "constitutionality of a rate" must depend on whether it offers the regulated company the ability to obtain a "fair return" on the regulated business alone.<sup>26</sup> Third, not allowing the opportunity for a fair return on regulated investment will inevitably discourage future investment and is therefore bad policy. Because both the Commission and the interexchange carriers are depending on the LECs' regulated network to be the backbone of competition,

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<sup>25</sup> As Bell Atlantic and NYNEX highlighted in their comments, Jack Grubman of Salomon Brothers found that new incremental marketing and customer service costs resulted in losses and "upward pressure" to GTE's cost structure. Mr. Grubman predicts similar impacts to the RBOCs as they enter the long distance market. First Call (Jan. 27, 1997).

<sup>26</sup> *Brooks-Scanlon Co. v. Railroad Comm'n of Louisiana*, 251 U.S. at 399. In that case, Justice Holmes, writing for a unanimous court, recognized that the Louisiana Railroad Commission could not justify requiring the operation of a money-losing railroad because the entire enterprise of the corporation was profitable. The Court found that the company could not be "compelled" to use profits from its competitive business to support continued losses in the regulated business. *Id.*

any policy that does not encourage continued network investment would kill the network goose that laid the golden egg of competition.<sup>27</sup>

Incredibly, MCI also argues that because “[f]irms in unregulated markets routinely risk losses,” there can be no constitutional protection for regulated companies.<sup>28</sup> This argument suggests that there could *never* be a sustainable takings claim. The losses that MCI would impose on the LECs are not routine competitive losses, however, but regulatory confiscation through the mandate of a rate level that does not recover actual costs.<sup>29</sup>

With the market openings mandated by the Act, all telecommunications providers will face increased competition in their core markets, but also will have the ability to generate additional revenues by entering new markets. It would be unreasonable to place a unique burden on the LECs by requiring that they not only find new revenue to make up for *competitive* losses, but also find new revenue to replace *regulatory* losses as well.

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<sup>27</sup> Mandating access prices at levels below actual costs would also undermine the incentive to build competing networks. To the extent a potential competitor could build a more efficient network, it would only do so if it could take advantage of those efficiencies. If LECs price at the level of hypothetical perfect efficiency, no new entrant, no matter how efficient, would have the incentive for facilities-based market entry.

<sup>28</sup> MCI at 31.

<sup>29</sup> While there is no constitutional protection for losses due to “economic forces,” due process does protect against “governmental destruction of economic values.” *Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548, 567 (1945)

The IXCs also try to justify their position by distorting the impact of the Commission's prior shift to price cap regulation. For example, AT&T claims that LEC shareholders should have anticipated that recovery for any investment made under price cap regulation is "at risk" because price caps gave LECs the flexibility to "manage their construction."<sup>30</sup> This simply is a rewrite of regulatory history. While price caps broke the direct link between specific costs and recovery, it was nevertheless designed to permit "recovery of total company costs while minimizing the adverse impact on consumers' surplus."<sup>31</sup> Indeed, the price cap rules recognize that a change in the separations rules is grounds for an exogenous adjustment to price capped rates.<sup>32</sup> If the Commission now decided to abandon price cap regulation and return to a rate structure directly linked to costs, which it should not, the fact that the intervening years were governed by price cap regulation would be irrelevant to setting new rates. Cost based regulation must provide the opportunity to recover all actual costs.

Similarly, it makes no sense to argue that LECs "had ample opportunity to seek adjustments to price regulation" that, prior to access reform, could have increased rates sufficiently to offset drastic cuts now.<sup>33</sup> Under both rate of return

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<sup>30</sup> AT&T at 32.

<sup>31</sup> *National Rural Telecom. Ass'n v. FCC*, 988 F.2d 174, 183 (D.C. Cir., 1993) (quoting *Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3257 (1988) ("Price Cap NPRM")).

<sup>32</sup> 47 C.F.R. § 61.45(d)(1)(iii).

<sup>33</sup> AT&T at 32.

and price cap regulation, LECs were offered an opportunity to earn a return on their investment. However, the Commission's depreciation policies, which created a reserve deficiency,<sup>34</sup> were based on the assumption that the LECs would be permitted to continue to charge rates that recover their capital costs. There could have been no legitimate expectation that the Commission would abandon its duties and force rates down to confiscatory levels.

The IXC's also claim that any profits during the period of price cap regulation should act as an offset to future losses.<sup>35</sup> This ignores the purpose of price cap regulation and the nature of the costs that must be recovered. Price cap regulation creates market-like incentives by allowing regulated companies to keep profits that they earn by becoming more efficient or introducing services that generate increased demand. IXC's can no more appropriate past profits than they can appropriate income from competitive services offered by the LECs. Indeed, to rely on such income would be a form of retroactive ratemaking that exceeds the Commission's authority.<sup>36</sup>

When the Commission allowed smaller companies to elect price cap regulation, it required that they make a one-time election so that a company

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<sup>34</sup> See Joint Comments at 27.

<sup>35</sup> See AT&T at 35.

<sup>36</sup> An action that "impose[s] new duties with respect to transactions already completed" is impermissively retroactive. *Landgraf v. USI Film Prods.*, 511 U.S. 244, 262 (1994). In this proceeding, the IXC's suggest the Commission impose new cost recovery burdens on past revenues.

could not game the system by building up its plant through capital investment under rate of return, and then converting to price caps for the period during which the plant improvements pay off.<sup>37</sup> The IXCs propose to take advantage of a regulatory change that would be the mirror image of this bait and switch. Additional plant investment is treated as endogenous under price cap regulation, which means that LECs receive no special recovery of any new investment. The investment was nonetheless made on the expectation that compensation would be achieved through the market in the form of greater profits as a result of efficiencies and new services. Now the IXCs would strip the LECs of any return on that investment by slashing prices to a cost-based recovery level that ignores past investment.

Moreover, the gap between recovery of hypothetical forward looking costs and actual costs also represents ongoing costs -- not simply a static pool of historical investment. The difference cannot simply be offset by prior returns or even amortized as suggested by Sprint.<sup>38</sup> Half of NYNEX's and Bell Atlantic's interstate costs are ongoing expenses, not tied to investment.<sup>39</sup> It also is wrong to think of historical investment as a static amount that can be amortized. Replacement investment must be made in the real world to match the needs of the existing network. Such needs may exceed projections of a theoretical

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<sup>37</sup> *National Rural Telecom. Ass'n v. FCC*, 988 F.2d at 179.

<sup>38</sup> See Sprint at 52.

<sup>39</sup> Joint Comments at 20, n.44.

incremental cost model, especially if such a model is based on an optimal network that never will exist. Finally, any bridging of the gap between TELRIC and actual costs must recognize recovery of all costs assigned to the interstate jurisdiction, not just those costs that the IXCs grudgingly recognize without regard to current separations mandates.

AT&T also seeks to circumvent full cost recovery by claiming that TELRIC may provide more revenue than a recovery based on actual costs.<sup>40</sup> Obviously, where that is true, TELRIC would not harm the LEC.<sup>41</sup> But AT&T's argument avoids the fundamental principle that the Commission must allow for a reasonable return on *all* actual investment.<sup>42</sup> How a hypothetical forward looking cost compares to that recovery is irrelevant.

IXCs also claim that the cost difference is, at least in part, attributable to over-investment by the LECs during price cap regulation.<sup>43</sup> This argument turns the last decade of regulation on its head. Incentive regulation was adopted to allow the market to reward sound investment and penalize unreasonable

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<sup>40</sup> AT&T at 33.

<sup>41</sup> Because AT&T only compares the cost of facilities that it defines as necessary to provide access services, it ignores costs for additional facilities that have been allocated to the interstate jurisdiction for recovery through access rates.

<sup>42</sup> *Duquesne Light Co. v. Barasch*, 488 U.S. at 300.

<sup>43</sup> See P. Kravtin, L. Selwyn, "Assessing Incumbent LEC Claims to Special Revenue Recovery Mechanisms," attached to AT&T Comments.

investment.<sup>44</sup> Under price caps, LECs get no regulatory benefit for additional investment, the only payback is through the market.<sup>45</sup> It is ironic that AT&T argues otherwise given the fact that their witnesses have argued the opposite view in other fora,<sup>46</sup> and AT&T's own equipment policies encouraged the very investment that they criticize.<sup>47</sup>

Finally, the IXCs argue that "a takings claim would be premature and could only arise after a Commission order applied to particular property was found to depress firm earnings below a level that permitted the LEC to raise capital, and went uncorrected by the Commission."<sup>48</sup> While it is true that in order to recover *damages*, LECs would have to make a showing of past financial harm, that is not the issue before the Commission in this rulemaking. The

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<sup>44</sup> Not surprisingly, the study submitted by AT&T "is seriously flawed and does not support the conclusion that LEC plant is overbuilt." J. Rohlfs, C. Jackson, R. Richardson, "The Depreciation Shortfall," filed as Attachment 4 to the USTA Reply.

<sup>45</sup> See Reply Affidavit of Robert W. Crandall at ¶ 16 (attached as Exhibit 1) ("Crandall Reply Affidavit") ("the Commission embraced price caps as the appropriate mechanism to control the LECs' interstate rates during the transition to competition because they allow the LECs to recover their costs and induce them to pursue cost minimization"). Moreover, to the extent that LECs made investments under a rate of return regime, the local regulators determined whether that investment was reasonable.

<sup>46</sup> See L. Selwyn, "Financing RBHC Diversification: Patterns of Investment in Non-LEC Ventures," Economics and Technology, Inc. (1993).

<sup>47</sup> The "inevitable consequence" of AT&T "capping features" that were available on its 1AESS switch was an acceleration of the LEC transition to digital switches. J. Rohlfs, C. Jackson, R. Richardson, "The Depreciation Shortfall," filed as Attachment 4 to the USTA Reply.

<sup>48</sup> AT&T at 41, n. 67.

Commission must decide the going-forward rate setting mechanism. If the Commission were to prescribe a rate cut that did not allow for recovery of actual costs, such a mechanism would itself violate the Constitution. As the 8th Circuit recently recognized, TELRIC-based rates would impose "economic losses beyond those inherent in the transition from a monopolistic market to a competitive one."<sup>49</sup> As a result, a cut to TELRIC levels would cause irreparable harm.<sup>50</sup> Because those losses would undermine the ability of LECs to earn a reasonable return on their investment, such a policy would be unlawful.

### **III. A Market-Based Approach Would Encourage Efficiency And Competition. (Paras. 161-217)**

#### **A. Pricing Flexibility Should Be Authorized As Soon As A State Approved Interconnection Agreement Is In Place. (Paras. 161-163, 168-200)**

In their initial comments, Bell Atlantic and NYNEX demonstrated why the pricing flexibility reforms proposed by the Commission are beneficial regardless of the level of competition, and why they should be put in place as soon as an interconnection agreement is approved by a state regulator.<sup>51</sup> Potential competitors argue that pricing flexibility should be delayed until after LECs have suffered substantial competitive losses. But such a policy would put the

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<sup>49</sup> *Iowa Utilities Board v. FCC*, Case No. 96-3321, Order Granting Stay Pending Judicial Review at 18 (8th Cir., Oct. 15, 1996).

<sup>50</sup> *Id.* at 18-19.

<sup>51</sup> *See* Joint Comments at 42-60.

Commission in the position of handicapping the LECs in their efforts to meet new competition.

Despite its opposing view here, AT&T has recognized this concern in the context of its efforts to obtain even greater pricing flexibility for its own services.<sup>52</sup> As AT&T recognized, freeing carriers to compete on price "affirmatively protects consumers by assuring the widest range of competition from the broadest array of carriers."<sup>53</sup> In contrast, consumers are harmed when the largest competitors "are shackled from competing openly and fairly."<sup>54</sup>

In arguing for its own relief, AT&T recognized that individual competitors have the ability to offer "unique competition,"<sup>55</sup> which "merits unique market responses."<sup>56</sup> Term and volume discounts, contract pricing, responsive pricing, and pricing freedom for new services allow discounts, but do nothing to alter the requirement that the underlying service be generally available at capped rates. As a result, just as AT&T claimed for its own proposals, these reforms "would only lead to lower, not higher, aggregate

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<sup>52</sup> AT&T is not alone in its reliance on pricing flexibility. One review of CLEC filings found more than 1300 contract tariffs. See *SBC RFP Tariff Transmittal Nos. 2433, 2499*, CC Docket No. 95-110, Direct Case Reply Comments (filed Oct. 10, 1995).

<sup>53</sup> **Policy and Rules Concerning the Interstate, Interexchange Marketplace**, CC Docket No. 96-61, AT&T Petition for Reconsideration at 8 (filed Sept. 16, 1996) ("AT&T Petition").

<sup>54</sup> *Id.*

<sup>55</sup> AT&T Petition at 7.

<sup>56</sup> AT&T Petition at 8.